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C O N F I D E N T I A L SECTION 01 OF 02 TEGUCIGALPA 001950

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TAGS: ECON EFIN PGOV SOCI HO
SUBJECT: HONDURAS: LOOSE MONEY: SPURRING GROWTH OR RISKING INFLATION?

REF: TEGUCIGALPA 1881

Classified By: Classified By: Charge James Williard for reasons 1.4 (b) and (d).

¶1. (C) Summary: In stark contrast to its unhelpful and seemingly improvised trade policies and crumbling fiscal discipline (reftel), the GOH has implemented a more coherent and thus-far successful (if risky) monetary policy. The GOH is pushing down interest rates and pushing up money supply, with the aim of increasing economic growth while keeping a lid on inflation. This policy has benefited from both a reservoir of technical competence in the Central Bank (BCH) and the legacy of solid macro-economic policies of the previous Maduro Administration. However, poor fiscal policies and rhetoric that threatens to chill investment could undermine this macro-economic stability, risking inflation. Economic growth seems to be increasing for now, but the GOH must keep a wary eye out for signs of inflation. End Summary.

¶2. (U) As Post has reported previously, the current GOH monetary policy targets monetary aggregates. Because there is no secondary bond market, the BCH intervenes through issuance of its own notes, rather than through open-market operations. At over 27 billion lempiras (USD 1.4 billion), the volume of these notes dwarfs that of the official GOH debt (bonds) issued by the Ministry of Finance (approximately 7 billion lempiras in tradable and 10 billion lempiras in non-tradable bonds). Regulations dating from a previous era of foreign exchange (forex) shortages still require 100 percent surrender of dollars, meaning all dollars are turned over to the BCH each night. These dollars are exchanged for lempiras, which must then be sterilized (bought back by the BCH to prevent uncontrolled expansion of the money supply). This sterilization is accomplished through Certificates of Monetary Absorption (CAMs), or short-term notes issued by the BCH.

¶3. (U) In a bid to increase liquidity to the credit markets, the Zelaya administration has chosen to forego the advice of the International Monetary Fund (which recommended issuing one billion lempiras worth of CAMs per month). Instead, according to Minister of the Presidency Yani Rosenthal, existing notes have been rolled over, but demand for new notes has been deliberately undersupplied. The result,

following competitive bidding by private banks for these secure and (formerly) high-yield instruments, has been to drive down the BCH target interest rate from 11.36 percent to 6.14 percent, a drop of 522 basis points in less than one year. In the most recent auction, yields hit 5.92 percent, suggesting that the GOH has overshot its target.

¶4. (U) The goal of this policy is to force private banks to place more capital in productive investments. Separately, bankers told Ambassador and EconChief that lack of juridical security and lack of sufficient high-quality projects hampers placing this much fresh capital this quickly. Nevertheless, Rosenthal maintains that the falling BCH rates have spurred a boom in construction, with a 41 percent jump in construction permits over last year, and an estimated 40,000 new construction jobs created. Post notes that according to figures from the Honduran Bankers Association (AHIBA), commercial lending rates have come down only slowly since 2001, falling from 22 percent to 15.7 percent today. At the same time, yields on deposits have fallen as well, leaving the Hondurans banks with generous interest rate spreads of nearly 800 basis points. Consequently, Post assesses that the impact of falling rates at the BCH is likely to be muted somewhat by Honduran banks' tendency to reduce their interest rates only slowly. It should also be noted that many of the construction projects cited by Rosenthal -- such as expansion of the airport (USD 40 million), initiation of a hotel complex in Tela Bay (USD 25 million), and expansion of the cement monopoly owned by Minister Rosenthal and his father (USD 110 million) -- are dominated by the traditional economic elites and do not yet represent broad-based growth. Ironically, Rosenthal levels the same criticism at the Maduro administration, alleging that its 3 to 4 percent per year

growth was concentrated in the energy and cellular telecommunications sectors.

¶5. (U) Rosenthal claimed growing exports are another cause for optimism, citing a 14 percent increase in textile exports. (Comment: In reality, the 14 percent figure he cites is accurate only for a year-on-year comparison of July 2006 with July 2005. A comparison of year-to date figures for 2006 versus 2005 shows a 9.6 percent decline in exports by value. This is only slightly better than the losses for the CAFTA block as a whole, which are down 10.81 percent year-on-year. The only winner in the CAFTA block thus far has been Nicaragua, with gains of 14.77 percent over 2005, thanks to Tariff Preference Levels contained in CAFTA. According to the Honduran Manufacturers Association (AHM), this erosion of market share is due to increasing competition from East Asia. Interestingly, the PRC -- which lost 12.48 percent year-over-year -- is not the primary beneficiary following the expiration of the Multi-Fiber Agreement. Rather it has been Bangladesh (16.67 percent increase), Indonesia (21.34), Vietnam (26.0) and Cambodia (29.39) that have taken market share from both CAFTA countries and from established suppliers such as the PRC and Mexico. End Comment.) The Honduran textile sector has created nearly 7,000 new jobs since January, but peaked in June and has lost jobs in each of the last two months. At USD 340 million, textile plant investment in 2006 is ahead of its historic pace of USD 200 million per year, led by the Green Valley project of U.S. firms Parkdale and Delta. The AHM therefore expects a rebound in employment next year as those new plants come on-line.

¶6. (U) The most significant threat from Zelaya's monetary policy is that it could spark inflation. At present inflation is below 7 percent, but an estimated 1.8 percent of that reduction is due to artificially low energy prices resulting from a GOH-imposed price freeze. Also keeping inflation low for the moment is the low inflation rate in the U.S., Honduras' key trading partner. As Honduran remittances grow, consumption is climbing, but most consumption is being supplied by imports from the United States. The U.S. is such

a large market compared to Honduran demand that growth of that demand exerts little to no impact on U.S. prices. In effect, Honduras is importing disinflation. There is a real question, however, of how long this can last. Prices for staples such as sugar, bread, and beans have recently started to rise, a phenomenon Rosenthal says the GOH "will have to look at closely." The GOH will need to issue additional bonds "at the first sign of increasing inflation."

¶7. (C) Comment: So far, the GOH strategy of priming the pump by increasing liquidity seems to be working. However, some, including former President of the Central Bank Victoria Diaz, have expressed to EconChief their concerns that the drop in interest rates was too far, too fast. Moreover, only strong domestic growth can absorb the additional liquidity -- in other words, if the growth is not forthcoming, the GOH could be setting itself up for resurgent inflation. Given the GOH's questionable, sometimes hostile rhetoric and policies (reftel) toward investment, many potential investors are likely to think twice about moving to Honduras. Without consistent large-scale investment, the foundations for the needed sustained growth cannot be laid. The success of Zelaya's loose money policy presupposes a continuation of the macroeconomic stability of the Maduro years. Without strong investment and fiscal discipline, however, the Zelaya administration might be weakening that very stability, and increasing the risk of inflation. If this works, growth will accelerate and Zelaya will be praised as a visionary. If it fails, he will be reviled as the man who squandered Honduras' best chance and plunged the country back into austerity. Post will continue to follow developments with interest. End Comment.

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